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credit

Understanding Credit Costs

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Using credit is promising to pay in the future for something you get now. You can use and enjoy what you are buying while you pay for it.

But credit has strings attached. When you promise to pay for something over a long period of time, you must pay a charge for the use of someone else's money. This is called INTEREST. There may be other costs of using credit, too.

What To Look For

If you want to borrow money or open a credit account, you will want to know how much you will be paying for the use of credit. By remembering two terms, you can find out how much you are paying in credit costs and be able to compare the cost of credit from different lenders. The two terms are the **Finance Charge** and the **Annual Percentage Rate.**

The **Finance Charge** is the total dollar amount you pay to use credit. It includes interest costs and other costs, such as service charges or credit-life, accident or health insurance premiums. For example, borrowing $100 for a year might cost you $12 in interest. If there is also a service charge of $5, the finance charge, or cost of credit, would be $17.

The **Annual Percentage Rate** is to credit what price per pound or unit pricing is to food or miles per gallon is to a car. It is the percentage cost of credit for a year and it is your key to comparing costs. There are many other ways to state the cost of credit as a percentage — for example, a "discount" rate, a "periodic" rate or "add-on" rate. **But only the Annual Percentage Rate (APR) gives a way to compare credit costs on an equal basis.**

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Just as hamburger at $1 per pound is a better buy than hamburger at $2 per pound, a lower Annual Percentage Rate gives you more for your money.

For example, if Creditor A offers you credit at an Annual Percentage Rate of 18 percent and Creditor B offers a 24 percent Annual Percentage Rate, you know that 18 percent is less than 24 percent. The cost of credit will be less from Creditor A. Compare Annual Percentage Rates to get the best buy when you use credit.

All creditors — banks, credit unions, stores, car dealers, credit card companies, finance companies — **must** state the cost of their credit in terms of the **Finance Charge** and the **Annual Percentage Rate.**

Look for these terms to know how much you will be paying to use credit.

If you don't see them, **ask** for them — in writing — on the contract. If the creditor refuses to do this, do **not** sign the agreement or contract!

Cost of Credit

We know how to find out what credit costs are. But why are credit costs different?

The cost of credit depends on:

- **Who you borrow from**
- **Your credit rating**
- **How much you borrow**
- **How long you take to repay**

Who You Borrow from

Different creditors charge different rates for credit. Banks and credit unions may offer credit at lower costs than finance companies or stores that offer installment credit. It is a common belif that it is harder to qualify for credit at a bank or credit union. This is not always true! Different lenders have their own lending policies. It is wise to apply for credit from a lower-cost lender first. Remember to look for the finance charge and compare Annual Percentage Rates.

Your Credit Rating

Your credit rating is your ability and willingness to repay a debt. It is measured by your record of paying bills and how prompt and reliable you were in making past credit payments.

A good credit rating, or credit history, helps you to qualify for credit and helps to get credit at a lower cost.

How Much You Borrow

The smaller amount of money you need to borrow, the less your credit will cost.

For example, you are buying a car for $6,000. You want two years to pay for it. The annual percentage rate is 18 percent. Compare the cost of credit between borrowing the entire $6,000 and making a $1,000 down payment or a $2,000 down payment.

Down Payment	Amount Financed	Monthly Payment (rounded)	Total Finance Charge	Total Cost
$ 0	$6,000	$300	$1,189	$7,189
$1,000	$5,000	$250	$ 991	$6,991
$2,000	$4,000	$200	$ 793	$6,793

As the table shows, with no down payment and borrowing the entire $6,000, the finance charge is $1,189. To borrow $5,000, the finance charge is $991. To borrow $4,000, the cost is $793. That is $396 less than with no down payment.

As you can see, the bigger the down payment you can afford, the lower the finance charge will be. Also, it reduces your monthly payment.

How Long You Take To Repay

The longer you take to repay your debt, the more you pay for credit.

For example, you are buying the same $6,000 car at 18 percent annual percentage rate with no down payment. The cost will vary with how long you use the credit. Compare the costs for two-, three- or four-year financing.

Time to Repay	Amount Financed	Monthly Payment (rounded)	Finance Charge	Total Cost
2 years	$6,000	$300	$1,189	$7,189
3 years	$6,000	$217	$1,809	$7,809
4 years	$6,000	$176	$2,460	$8,460

The total cost over two years would be $7,189. For four years it would be $8,460. The difference is $1,271!

Take the shortest amount of time to repay a debt and make the highest monthly payment you can safely afford.

HOW TO KEEP CREDIT COSTS DOWN

- LOOK FOR THE FINANCE CHARGE TO TELL YOU HOW MUCH YOU ARE PAYING FOR CREDIT.
- SHOP FOR THE LOWEST ANNUAL PERCENTAGE RATE (APR).
- BORROW THE LEAST AMOUNT POSSIBLE.
- MAKE THE LARGEST DOWN PAYMENT YOU CAN.
- PAY BACK THE LOAN AS FAST AS YOU CAN. ARRANGE FOR THE HIGHEST MONTHLY PAYMENT YOU CAN SAFELY AFFORD.
- PAY YOUR BILLS ON TIME. PROTECT YOUR CREDIT RATING.
- ONLY USE CREDIT WHEN YOU REALLY NEED IT.

Other publications in this series include:

L-1882 Deciding When to Use Credit
L-1883 When You Apply for Credit
L-1884 What Is Credit?
L-1885 Using Credit Cards
L-1886 Borrowing Money
L-1887 Handling Credit Problems
L-1888 Buying on the Installment Plan

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